

THE PAY FOR PERFORMANCE DILEMMA

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Empirical evidence from the United States indicates a statistically significant relationship — but not a particularly strong economic relationship — between the CEO's remuneration and corporate performance. In Australia, the limited number of studies in this field have found that CEO pay is related to company size (the larger the company, on average the higher the pay) but is not linked in any clear way to corporate performance. This article analyses the factors which may explain the lack of a strong link between executive pay and company performance in Australia. Some of these are consistent with the board-capture theory articulated by Bebchuk and Fried.

Introduction

It is not surprising that many shareholders and other stakeholders in a publicly listed company would expect the remuneration — or at least part of the remuneration — of the Chief Executive Officer (CEO) and other senior executives to bear some relationship to the performance of the company itself. After all, financial economists generally predict this relationship on the basis that senior executives' pay arrangements should operate as a partial remedy to the agency problem.¹ Under this optimal contracting approach to executive compensation, the board — or, more specifically, the remuneration committee of the board — is assumed to design remuneration packages to provide senior executives with efficient incentives to maximise shareholder value.²

The evidence from US studies indicates a statistically significant relationship — but not a particularly strong economic relationship — between the CEO's remuneration and corporate performance.³ In Australia, the limited number of studies in this field have found that CEO pay is related to company size (the larger the company, on average the higher the pay), but is not linked in any clear way to corporate performance.⁴

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¹ Bebchuk and Fried (2003).

² Bebchuk and Fried (2003).

³ See, for example, Boschen et al (2003); Guay et al (2001); Murphy (1999), p 2485; Hall and Liebman (1998); Boschen and Smith (1995); Jensen and Murphy (1990). But cf Bertrand and Mullainathan (2001) (evidence that the cash component of executives' pay increases in line with profit increases — even where the increase in profit has nothing to do with management skill or effort).

⁴ See below, n 23.

One line of scholarship that endeavours to explain why there is not a strong relationship between executive compensation and company performance is the 'board capture' theory.⁵ Under this theory, the board of directors (and the remuneration committee of the board) is 'captured' by the company's CEO, with board dynamics and social dynamics discouraging non-executive directors from being overly demanding in formulating executive pay packages.⁶ As Bebchuk and Fried explain, under this approach, 'executive compensation is viewed not only as a potential instrument for addressing the agency problem — but also as *part* of the problem itself'.⁷

It is not the purpose of this article to enter — in a substantive way — the debate about the board-capture theory of executive compensation. Rather, the aim of the article is to highlight several factors that could explain why CEO pay goes up while company performance stagnates or declines. Some of these are consistent with the board-capture theory.

The structure of the article is as follows. The next section gives an overview of the components of executive compensation that might be linked to company performance. The third section describes how a long-term incentive plan provides incentives to executives to run the company's business in a shareholder wealth-maximising fashion. This is followed by a brief overview of the findings of Australian empirical studies of the determinants of executive remuneration. The main part of the article analyses the various factors which may explain the lack of a strong link between executive pay and company performance in Australia.

Which Components of Executive Pay Might be Tied to Performance?

In theory, several components of an executive's remuneration could be tied to corporate performance. Base salary could certainly be contingent on various measures of (past) company performance, as could the short-term cash bonus and the long-term incentive (eg options grant). Superannuation and perks such as use of a motor vehicle are less easily tied to company performance.

In practice, the two components of executive remuneration which are usually contingent on some aspect of company performance are the short-term incentive (commonly called the 'annual bonus', and most often paid in cash)⁸

⁵ See Bebchuk et al (2002); Hill and Yablon (2002); Elson (1996).

⁶ Thomas (2002).

⁷ Bebchuk and Fried (2003). For critiques of the board-capture theory, see Thomas (2002); Murphy (2002); Hall and Murphy (2003).

⁸ Some companies have started to award senior executives' annual bonus in the form of shares, rather than cash. See, for example, TABCORP Holdings Limited, *Notice of Annual General Meeting 2003*, p 6 (notes to Resolution 6). One company that had been a pioneer in this area, AMP Limited, has recently abandoned the idea and reverted back to a cash annual bonus: *AMP Shareholder Report: Concise Annual Review 2003*, p 36.

and the long-term incentive. Short-term incentives are discussed later in the article.⁹

The most popular form of long-term incentive among the S&P/ASX 200 companies is the traditional option. This is an option which has an exercise price equal to the market price of the company's shares at the time the option is granted. During 2003, shareholders were asked to vote on 71 new, amended or re-approved long-term incentive plans at the top 200 companies listed on the Australian Stock Exchange (ASX).¹⁰ In 40 instances (56 per cent of cases), the incentive plan provided for the issue of traditional options.

With traditional options, if the plan's performance hurdles are satisfied, the executive is required to pay to the company the 'exercise price' for each option — and the exercise price is typically the market price of the company's shares at the time the options were granted (say, three years earlier). The executive will, of course, only exercise the options if the share price at the vesting date is greater than the exercise price. The fact that the executive stands to make money — possibly lots of money — if the share price at vesting is above the exercise price, but stands to make absolutely nothing if the share price at vesting is *below* the exercise price, can be described as the 'all or nothing' feature of traditional options.

The next most popular type of long-term incentive is the zero exercise price option (ZEPO). Companies usually describe ZEPOs as 'performance rights', 'performance award rights', 'performance shares', 'allocation rights', 'deferred shares' or something similar. (The term ZEPO is used only very rarely in incentive plans, company annual reports and AGM notices of meeting.)

In contrast to traditional options, the executive pays nothing to the company when exercising ZEPOs. Under a typical ZEPO plan, the executive is granted 'performance shares' which are 'frozen' for a period (that is, the executive cannot sell them). Then, if the plan's performance hurdles are met and the executive is still employed by the company at the end of the freeze period, the executive will become unconditionally entitled to the shares — and will be able to sell them and make some money. The amount of money made will depend on how the company's share price has performed since the ZEPOs

⁹ See AMP Limited, *Notice of Annual General Meeting (2003)*, Explanatory Notes — Annexure B; see also n 31 below and accompanying text.

¹⁰ Equity Strategies Pty Ltd (2004), p 4. Shareholder approval is normally sought under Listing Rule 10.14 — which requires shareholder approval before a listed company issues any equity security to a director; or Exception 9 to Listing Rule 7.1. Under Listing Rule 7.1, companies cannot issue shares representing more than 15 per cent of their equity, in any 12-month period, unless they obtain shareholder approval. An exception exists for shares issued under an 'employee incentive scheme' (this concept includes employee share schemes, executive share plans, and executive option plans). The exception works like this: shares issued under an employee incentive scheme are not included in the 15 per cent limit if, within the past three years, shareholders have approved the future issue of shares under the scheme. This means that the 15 per cent limit can be 'devoted to' other share issues.

were granted. But, even if the share price has fallen since the grant date, the executive stands to make something.

Of the 71 new, amended or re-approved long-term incentive plans voted on by shareholders at S&P/ASX 200 companies in 2003, 21 (or 30 per cent) were ZEPO plans.¹¹ ZEPOs have become increasingly popular, with several companies publicly abandoning traditional options and replacing them with ZEPOs.¹²

So are there any advantages of ZEPOs compared to traditional options? Arguably, ZEPOs present significantly lower incentives to executives to 'cook the books' in order to increase incentive pay.¹³ A key reason for this is that, as indicated above, traditional options can involve an all-or-nothing scenario — where the executive stands to make millions if the market price of the company's shares is above the options' exercise price when the vesting time arrives, but nothing if the market price is below the options' exercise price. With ZEPOs, as outlined above, it is not an all-or-nothing scenario. Provided that the plan's performance hurdles have been met (and these may be purely 'relative' hurdles),¹⁴ the executive will receive full legal and beneficial ownership of shares, even if the company's share price has not moved above the price at the time the ZEPOs were granted (say, three years earlier).

In the aftermath of the corporate collapses and scandals that rocked the United States in 2001/02 (Enron, Worldcom, etc), there appears to be a benefit to company shareholders in ensuring that executive incentive plans do not lead to distorted incentives. This may justify moving away from traditional options (with their 'all or nothing' characteristics) towards ZEPOs.

But the perspective of the executive should not be overlooked. Why should an executive prefer ZEPOs over traditional options? In a bear market (with share prices falling more commonly than rising), a ZEPO plan can reward an executive even though the company's share price falls from the time the ZEPOs are granted to the time the executive is entitled to exercise them (ie the vesting date). But in such a market, an executive would get nothing at all from a traditional option plan, under which the exercise price is set as the market price at the time the options were granted.

The Australian market was a bear market for much of the period 2000–2002 — just as ZEPOs became more popular. The fact that executives may

¹¹ Equity Strategies Pty Ltd (2004). After traditional options and ZEPOs, the next most popular form of long-term incentive is an interest-free loan to acquire shares.

¹² See, for example, Commonwealth Bank (2002).

¹³ There is some evidence that distorted incentives relating to options was one factor in the collapse of Enron: Coffee (2003). Also, there is US empirical evidence that the nature and timing of earnings forecasts and other information disclosures by management are related to executive options grants: Yermack (1997) (finding that the patterns of companies' quarterly earnings announcements are consistent with an interpretation that CEOs are granted options shortly before favourable corporate news is released); Aboody and Kasznik (2000); Yablon and Hill (2000); Hallock and Oyer (1997). See also Conference Board Commission (2002).

¹⁴ Equity Strategies Pty Ltd (2004); see also nn 26–27 below, and accompanying text.

prefer ZEPOs — at least in a bear market — may provide some support for the board-capture theory in Australia.

How Does a Long-term Incentive Plan Provide Incentives?

For many listed Australian companies, there are two ways in which a long-term incentive plan should provide incentives to senior executives to work hard and bring about improved company performance in the next few years.

First, traditional options are only ultimately of value to an executive if the company's share price — at the vesting date — is higher than it was when the options were granted. If the share price at vesting date is below what it was at grant date, a rational executive will not exercise the options. They will lapse. So, at least as far as traditional (market exercise price) options are concerned, there is an incentive for the executive to do whatever is within his or her power to bring about an increased share price. Preferably, of course, the executive will be doing things that are legal and in accordance with accepted commercial practice. The corporate collapses and scandals of 2001/02 indicate, however, that the incentive to 'get the share price up' can sometimes lead to inappropriate and even illegal conduct.

The second way in which a long-term incentive plan can provide a performance incentive to executives is through a separate 'performance hurdle' being attached. For a plan that uses traditional options, a performance hurdle is designed to function as a separate — additional — incentive, over and above the incentive that exists via the need to get the share price up above what it was at grant date. Performance hurdles are defined, and examples of commonly used hurdles are outlined, later in this section.

For a ZEPO plan, the performance hurdle is the most significant incentive. While the executive still has an interest in the company's share price being as high as possible at the vesting date, even if it turns out to be lower — at vesting date — than it was at grant date, the executive may still gain full economic ownership of valuable securities (fully paid ordinary shares). But this will only be the case if the performance hurdle is satisfied.

Given that an executive who holds ZEPOs can still make money even if the share price at vesting date is lower than it was at grant date, it is not surprising that performance hurdles are *de rigueur* for ZEPO plans. All 21 ZEPO plans that were voted on by shareholders in S&P/ASX 200 companies during 2003 incorporated at least one performance hurdle.¹⁵

Corporate governance guidelines in the United Kingdom and Australia universally recommend that a long-term incentive plan should incorporate one or more performance hurdles. For example, the share and option plan guidelines of the Investment and Financial Services Association (IFSA) recommend that executive incentive plans should contain demanding performance hurdles. These performance requirements should provide incentives to executives to bring about 'materially improved company performance in terms of medium to long-term growth of the company and

¹⁵ Equity Strategies Pty Ltd (2004).

resulting shareholder value'.¹⁶ The guidelines of the Australian Council of Superannuation Investors (ACSI) recommend that 'performance conditions for remuneration and share incentive plans should be designed to reward executives for contributing to long term above average corporate performance'.¹⁷ And the guidelines of the Association of British Insurers (ABI) recommend:

Challenging performance conditions should govern the vesting of awards or the exercise of options under any form of long term share-based incentive scheme. These should:

- relate to overall corporate performance
- demonstrate the achievement of a level of performance which is demanding in the context of the prospects for the company and the prevailing economic environment in which it operates
- be measured relative to an appropriate defined peer group or other relevant benchmark
- be disclosed and transparent.¹⁸

The most common hurdle amongst S&P/ASX 200 companies is total shareholder return (TSR) — which is, in essence, the growth in the company's share price plus dividends paid (and assumed to have been reinvested) during the year. Of the long-term plans that were voted on by shareholders in the top 200 companies during 2003, 49 per cent used TSR as their principal or only performance measure.¹⁹ The next most common performance measure (15 per cent of cases) was earnings per share. Next (14 per cent) was a hurdle that required appreciation in the share price above the market price at grant date. A share price appreciation hurdle may be explicit or implicit. It is explicit if the options are market exercise price options, and there is a performance condition stating that the company's share price must be at or above a designated level (which would be higher than the exercise price) on the vesting date. It is implicit if the exercise price of the options is set (at grant date) at a level higher than the market price of the company's shares on the grant date.

A performance hurdle may be 'absolute' (eg the company's TSR must grow by at least 10 per cent per annum, on average, over a three-year vesting period). Or it may be relative (eg the company's TSR over a three-year vesting period must place the company at least at the median, when it is ranked against the TSR of a group of peer companies).

In the United States, it is extremely uncommon for a performance hurdle to be attached to a grant of options.²⁰ There are two explanations for this. First,

¹⁶ IFSA (2002), para 7.1

¹⁷ ACSI (2003), Section 13.3.

¹⁸ Association of British Insurers (2003), para 6.2.

¹⁹ Equity Strategies Pty Ltd (2004).

²⁰ One recent exception is IBM: The company announced in early 2004 that future option grants to senior executives would have an exercise price set at 10 per cent above the market price on the date of grant: 'IBM Announces Significant Changes in Senior Executive Compensation Policies', Press Release, IBM Corporation, 24

under present US accounting rules (GAAP), a company that issues 'plain vanilla' (ie traditional, market exercise price) options, without any additional performance hurdle, is not required to include the value of the options in the expense section of the Profit and Loss (P&L) Statement. However, if the exercise price is 'indexed' to the market return or industry return (which in substance is a performance hurdle), then the options would need to be expensed.²¹ Second, it would appear to be tax disadvantageous for a US company to attach a performance hurdle to executive options.²²

Pay for Performance: The Australian Evidence

Six Australian studies have all found no consistent, statistically significant, relationship between CEO pay and corporate performance in listed Australian companies.²³ This was the case regardless of whether performance was measured in terms of share price or various accounting measures. On the other hand, each study that included a measure of company size as a variable found a positive relationship between company size and CEO pay — which lends some support to the managerialist theories that managers have incentives to maximise firm sales rather than profits.²⁴

Reasons Why Pay May Not be Closely Linked to Performance

There is no single or easy explanation for a lack of connection between CEO pay and company performance. Some factors that may play a role are outlined below. Although long, this is probably not a comprehensive list.

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For academic commentary on the pros and cons of US firms incorporating performance hurdles into their option plans, see Meulbroek (2001); Garvey and Milbourn (2001).

²¹ DeMott (2000). Under IFRS 2 'Share-based Payment', published by the International Accounting Standards Board (IASB), the fair value of stock options granted to executives and other employees must be recognised as an expense in the P&L Statement over the options' vesting periods. The US Financial Accounting Standards Board (FASB) has also announced its intention to reassess the flexibility provided in FAS123 to either expense or disclose the fair value of stock options. The Australian Accounting Standards Board (AASB) has issued Pending Accounting Standard AASB 2 'Share-based Payment', which reflects IFRS 2. For the case in favour of expensing share options, see Guay et al (2003).

²² Schizer (2001).

²³ Koh et al (2004); Fleming and Stellios (2002); Coulton and Taylor (2002); O'Neill and Iob (1999); Izan et al (1998); Defina et al (1994).

²⁴ See, for example, Baumol (1967). Measures of company size used in the Australian studies include the natural logarithm of total assets — Fleming and Stellios (2002); Koh et al (2004) — and sales — Izan et al (1998); Defina et al (1994).

Relatively Small Proportion of Total Remuneration is 'At Risk'

At the time most of the Australian pay-for-performance studies were conducted, the typical Australian CEO had a relatively small percentage of total remuneration 'at risk', compared with a typical US executive. More precisely, the data used in most of the studies were drawn from the 1990s or earlier. However, as Table 1 shows, there has been a very sharp increase in the proportion of Australian CEO pay that is incentive-based — or 'at risk' — since the late 1990s.

Table 1 illustrates that, in 1987, the at-risk components of remuneration (short-term and long-term incentives) accounted for only 9.5 per cent of the average CEO's remuneration. However, by 2002, the at-risk components accounted for 57.2 per cent.

The impact of this factor on *future* empirical research into pay-for-performance should not be so pronounced, due to the significantly higher at-risk component of pay in recent years.

Table 1 Components of CEO remuneration: Large Australian companies

	1987	1990	1995	1998	2002
Fixed pay (% of total)	90.5	81.7	62.0	50.4	42.8
Short-term incentive (% of total)	3.2	5.0	10.1	14.5	23.2
Long-term incentive (% of total)	6.3	13.3	27.9	35.2	34.0
	100.0	100.0	100.0	100.0	100.0

Sources: For 1987 to 1998: Australian Human Resources Institute, Executive Remuneration Research Project: Executive Remuneration in Australia: An Overview of Trends and Issues (1999). For 2002: IA Research, *CEO Pay in the Top 100 Companies: 2002* (Research Paper prepared for the Australian Council of Superannuation Investors, 2003), p 23.

Long-term Incentive Plan Has No Performance Hurdles

In some cases, the long-term incentive plan (eg executive options plan) has no performance hurdles. This is so for only a handful of S&P/ASX 200 companies — one of which is noteworthy: News Corporation Limited.²⁵

In this situation, options issued under the plan can still function as an incentive to improve the share price — because any increase above the exercise price will be profitable for the executive. However, that is the only respect in which there is an incentive. In contrast, if there was a separate hurdle relating to the company's TSR, then the executive would have an

²⁵ See the *News Corporation Limited Notice of Annual General Meeting, 2003*, Special Business, Item 1. Proposed Resolution 1 was withdrawn by the company before the meeting after considerable pressure from institutional shareholders who were dissatisfied with the absence of performance hurdles.

interest not only in the share price, but also in the level of dividend per share being improved.

Long-term Incentive Plan's Performance Hurdles Do Not Relate Directly to Share Price or Dividends

In some cases, the long-term incentive plan's performance hurdles do not relate directly to share price or dividends. For example, some plans have performance hurdles relating to accounting measures of financial performance (eg a specified percentage growth in earnings per share or in net profit before tax). It is possible that these performance hurdles could be achieved without any significant improvement in the company's share price and without any increase in dividends.

For example, an increase in net profit before tax could be achieved via an acquisition. But if that acquisition was funded wholly or partly with equity (ie through an issue of shares), the acquisition may be 'earnings per share dilutive'. That is, the amount of profit attributable to each ordinary share may be lower after the acquisition because the increase in profit brought about by the acquisition is more than off-set by the increased number of shares on issue.

Where a hurdle is related to an accounting measure of performance, and the hurdle is met without an improvement in shareholder return, any shareholder who regards 'performance' as being first and foremost an impressive share price trend and gradually increasing dividends would not believe that the CEO had been paid in line with the company's performance. And any academic study that used a share-price-related measure for performance would similarly be affected.

Long-term Incentive Plan Uses Relative Performance Hurdles

In an increasing number of cases, the long-term incentive plan has 'relative' rather than 'absolute' performance hurdles.²⁶ With relative hurdles, the company's performance is compared against that of other companies. The hurdle may be satisfied even if the company's share price and dividends have fallen — provided that in a relative sense the company has fared well compared to its peers.

The trend towards 'relative' performance hurdles has been accompanied by a trend towards 'variable reward'. Here, the number of options/performance shares that vest is determined by how good the company's performance is. There is usually a sliding scale, the effect of which is: the better the company's performance, the more options that vest. But the issue in terms of pay for performance is that these sliding scales very often provide for 50 per cent of options to vest when the company's performance is at the median.

²⁶ See Equity Strategies Pty Ltd (2004), p 5: 'In 2003, in a sample of approximately 200 companies, TSR was used in 39 new, amended or re-approved plans. Only two of these plans used a benchmark of percentage growth in TSR, the rest required comparison with a specified group, either an S&P/ASX index or a selected peer group.'

An increasingly common hurdle looks like this: the hurdle relates to the company's TSR. The hurdle is a relative hurdle, and it requires the company's TSR to be measured against the TSR for each other company in a comparator group (eg the companies making up the S&P/ASX 100 index). The number of options the CEO can exercise depends on where the company sits compared with the other companies, when they are ranked from best to worst:

- If the company is ranked below the median, no options vest.
- If the company is ranked at the median, 50 per cent of the options vest.
- If the company is ranked between the 51st percentile and the 74th percentile, the CEO can exercise between 52 per cent and 98 per cent of the options, rising on a straight line basis.
- If the company is ranked at or above the 75th percentile, the CEO can exercise all the options.²⁷

In summary, even if the company's performance is just average, perhaps 50 per cent of the maximum number of options will still vest.

Long-term Incentive Plan Allows Performance to be Tested on Multiple Dates

In some cases, the long-term incentive plan allows performance to be tested on multiple dates. Sometimes the degree of latitude involved is very considerable. This may mean that the executive becomes entitled to exercise his or her options even though the company's performance has been sub-standard for all but a short period of time.

For example, in one case the hurdle required the company's TSR to have outperformed the All Ordinaries Accumulation Index as measured on 20 consecutive trading days during a specified window. The window was effectively several years. There would be a great number of different '20 consecutive trading day' periods that could be chosen to test the company's performance, and the company's TSR would need to exceed the All Ordinaries Accumulation Index on only one of those 20-day test periods in order for the executive to become entitled to exercise their options. That is, the company could *under-perform* the benchmark during all but one test period, and the executive could still exercise their options. The executive could be rewarded under this scheme even though there was no materially improved relative company performance.

Long-term Incentive Plan Uses ZEPOs Rather than Traditional Options

As indicated above, it is becoming increasingly popular for S&P/ASX 200 companies to use ZEPOs, rather than traditional options, as the long-term incentive for senior executives. Subject to the point below, the use of ZEPOs can provide part of the explanation for why executive pay has risen during a period when the company's share price has fallen.

The fact that some companies are using ZEPOs will not *necessarily* affect a pay-for-performance regression study. In terms of the econometrics, whether

²⁷ See, for example, CSL Limited, *Notice of Annual General Meeting* (2003), Explanatory Notes to Resolution 5.

this factor is relevant will depend on the date at which the ZEPO is valued. It is very common in Australia now for companies to value their executive options (and other long-term equity incentives) at 'grant date' — that is, as at the date the options/incentives are issued to the executive. It may be that the executive cannot exercise the option for another three years (that is, there may be a vesting period of three years). But, nevertheless, it is common to do a valuation at that initial date — using a method such as Black-Scholes. If ZEPOs are valued at the date they are granted, then the factor described in this sub-section should not be treated as contributing to any lack of correlation between executive pay and company performance.

However, in the past, some companies calculated the value of options/incentives when vesting occurred — that is, at the date when the executive is able to 'convert' the options into ordinary shares (and in a few rare cases this still happens).²⁸ If ZEPOs are valued at the date when they vest, and the company's share price has fallen since the date the ZEPOs were granted, this can show up as an increase in CEO pay following a period of poor company performance.

Long-term Incentive Grants Can be 'Lumpy'

Grants of options (or performance rights, deferred shares, etc) are quite commonly made to a particular executive only once every three years or so. And, until recently, the generally accepted practice in Australia was that options were valued *in full* at the time they were granted (rather than at the time the executive actually makes money out of them — when they vest). Taken together, these two common practices meant that a pay-for-performance study which looked at the CEO of Company A during the year in which the CEO was granted 500 000 options would report a significantly larger annual remuneration for that CEO than if the study looked at the CEO in the following year — when no options were granted.

So the 'lumpy' nature of options grants needs to be borne in mind in assessing the merits of a study of pay for performance. However, in future this is not likely to be as serious an issue — for the following reason.

In June 2003, the Australian Securities and Investments Commission (ASIC) issued guidelines on the disclosure of options' value.²⁹ These guidelines — which contain ASIC's interpretation of section 300A of the *Corporations Act* insofar as it relates to options — state that companies should:

²⁸ In 2000, the accounting standard-setting bodies of Australia, Canada, New Zealand, the United Kingdom and the United States (called the G4+1 Group) released a Discussion Paper which recommended (a) expensing options in the P&L Statement, and (b) that the amount of the expense should be calculated by doing a valuation at the *vesting* date: AASB (2000). However, IFRS 2 (see n 20, above) requires options to be valued at the grant date, and then expensed proportionately over the vesting period (eg if the vesting period is three years, one-third of the grant-date value would be included in the P&L Statement as an expense in each of years 1, 2 and 3 after grant).

²⁹ ASIC (2003).

- calculate the value of options as at the date of grant; and
- then attribute that value across the vesting period, so that a proportionate amount is disclosed during each year of the vesting period.

So, if a grant of options to a CEO on 1 July 2004 was determined (using an appropriate valuation method such as Black-Scholes) to have a value of \$300 000, and the vesting period was three years, the company would be required to include in the CEO's disclosed remuneration the following amounts:

- \$100 000 for the financial year ended 30 June 2005;
- \$100 000 for the financial year ended 30 June 2006; and
- \$100 000 for the financial year ended 30 June 2007.

This spreading of the value should overcome the 'lumpy' aspect of options valuation that would probably have affected existing pay-for-performance studies.

The Impact of Prospective Performance Hurdles

Empirical studies of pay for performance commonly seek to find a relationship between CEO pay in year *X* and company performance in year *X* minus 1. That is, the hypothesis being tested is that the CEO's pay goes up if the company *has been* performing well, and goes down if it *has been* performing poorly.

However, when the two incentive components of pay (the short-term incentive and the long-term incentive) are teased apart, it becomes apparent that the researcher should not necessarily expect CEO pay to have a pronounced relationship with *past* company performance. The reason is as follows. The short-term incentive is often structured so that the CEO's remuneration is affected by company performance (often measured in an accounting sense) over the immediately preceding 12 months (hence the expression 'annual bonus'). But on the other hand, the long-term incentive is normally structured so that the CEO's remuneration is affected by *future* company performance. As O'Neill and Iob note: 'As such, a link to past company performance would not be expected.'³⁰

Short-term Incentive Plan's Performance Hurdles Do Not Relate Directly to Share Price or Dividends

In the vast majority of cases, the *short-term* incentive plan's performance hurdles do not relate directly to share price or dividends. Most large publicly listed Australian companies use performance measures other than share price and dividends in determining the short-term incentive for the CEO. This incentive is typically an annual bonus, and is most commonly paid in cash. The performance measures are often related to 'internal' performance more than external measures like share price.

For example, in one short-term incentive plan, the performance measures related to a series of quantitative measures (return on equity, cost management,

³⁰ O'Neill and Iob (1999), p 73.

total operating margins, value of new business) and qualitative measures (performance relative to competitors and market conditions, stakeholder perspectives, personal leadership, effective teamwork at senior management levels and strategic positioning).³¹

This is not necessarily problematic at all from a corporate governance perspective. Whether or not it is a problem will depend on the nature of the measures adopted — are they rigorous and defensible?

But it needs to be borne in mind that a sizeable annual bonus could be paid under a short-term incentive scheme even if the company's share price has fallen during the year in question.

Benchmarking

Most large companies use external remuneration consultants to assist in setting the CEO's pay. The consultants rely partly on benchmarking techniques. That is, they produce league tables indicating how much (and in what form) the CEOs of other companies (of comparable size and in comparable sectors) are paid.³²

This can partly explain (but not justify) why a CEO's base salary increases despite poor company performance:

Companies have a sort of institutional pride, and consciously paying a CEO below the average constitutes a blow to that institutional pride. Talk to a member of the board about this issue, and he'll likely tell you that 'our company is as good as anyone else's, and therefore we're not going to be cheap and pay below the average'.³³

A US empirical study by Bizjak, Lemmon and Naveen found that competitive benchmarking has had a non-trivial effect on compensation levels for the CEO and other senior executives. One specific finding was that CEOs who were paid below the median in period 1 received pay rises in period 2 that were twice as large as the pay rises of those CEOs who, in period 1, were paid above the median.³⁴

The United Kingdom's Greenbury Committee warned that if benchmarking was not approached with caution, 'the effect will simply be to ratchet up the general level of executive remuneration'.³⁵

Studies are Not Always Rigorous

The question 'Is CEO pay linked to company performance?' is one that is difficult to answer. It can be asked in relation to an individual CEO at a

³¹ AMP Limited, *Notice of Annual General Meeting* (2003), Explanatory Notes — Annexure B.

³² See Murphy (1999); Crystal (1991), pp 42–50, 218–25.

³³ Crystal (1991), p 221.

³⁴ Bizjak et al (2000).

³⁵ *Directors' Remuneration* (1995), para 6.12.

particular company. Or it can be asked in relation to the CEOs in a basket of companies — such as the Top 100 Australian companies.

When the question relates to the CEOs in a basket of companies, the way in which to answer the question is to conduct a rigorous statistical (regression) analysis. Some studies which have appeared in Australia recently purport to answer this question, but they do not use a sufficiently rigorous approach. For example, a recent study conducted for the Labor Council of New South Wales³⁶ relied on data in the *AFR Salary Reviews*.³⁷ However, the study has some important limitations which should be acknowledged.

First, the *AFR Salary Reviews* do not provide an accurate picture of what a CEO has actually been paid. This is because the reviews do not attempt to include the value of options or shares granted to the CEO during the financial year in question. Instead, figures are provided for all components of annual pay *except* options and shares granted, and then there are figures for the total value of shares and options owned by the executive. The latter figures are not meaningful in trying to assess whether pay is linked to performance because these options and shares will in many cases have been accumulated over several years, not just the financial year in question. Also, in some cases the executive has acquired these equity holdings other than by way of remuneration. An obvious example is Rupert Murdoch: the vast proportion of his shares in News Corporation were acquired by him or his family company many years ago, and were not granted to him as part of his remuneration for being News Corp's CEO.

Second, the New South Wales Labor Council study did not control for several variables which could (either in addition to or instead of company performance) be drivers of the CEO's pay. For example, variables such as the composition of the board's Remuneration Committee (was it mostly or exclusively composed of independent directors, or was the CEO or another executive director a member of it?), the number of years the CEO has been in the job, the CEO's age, the size of the CEO's shareholding in the company, and the industry in which the company operates have all been included in rigorous studies of pay-for-performance in the United States, the United Kingdom and Australia.

The findings of a study which purports to assess executive pay for performance across a large sample of companies should be qualified and treated cautiously if the study does not use fully developed regression analysis.

Conclusion

This article has highlighted a range of factors that could explain why — both in an individual case and also across a universe of companies — CEO compensation can increase while company performance stagnates or declines.

Some of these factors are consistent with the board-capture theory that has been debated rigorously in the United States in recent years. For example,

³⁶ Shields et al (2003).

³⁷ See, for example, 'Salary Review 2002' (2002).

the pronounced trend towards ZEPOs during 2000 to 2003,³⁸ as a substitute for or addition to traditional (market exercise price) options, contemporaneous with a bear market for much of that period, may provide some support for the board-capture theory in Australia.

In addition, several of the factors described in the article are relevant to the methodology employed in studies of pay-for-performance. Future Australian research in this field needs to take into account the types of practices described in this article if the research is to reflect satisfactorily the 'landscape' of senior executive remuneration.

Finally, shareholders (and regulators) who are interested in the potential for performance-related pay to help minimise agency costs should be aware that there are several reasons why theory may not translate into practice. The article has endeavoured to focus on the most significant of these in the Australian context.

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³⁸ See Equity Strategies Pty Ltd (2004); Equity Strategies Pty Ltd (2003), p 3.

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